Internal Revenue Service

memorandum

CC:WR:PNW:SEA:TL-N-426-00
KGMedleau

Date: JUN 1 2000

To: Bill Marx, Team Manager, MS W:102
Vince DiGioia, Revenue Agent

From: District Counsel
Seattle

Subject: [redacted] - Deductibility of Insurance Premiums; Economic Family Rationale

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You asked that we consider whether the structure of the transaction between [redacted] and [redacted] constitutes a captive arrangement that precludes a section 162 deduction for premiums paid by [redacted] to [redacted] during [redacted] and [redacted] under the economic family rationale set forth in Rev. Rul. 77-316. For the reasons I discussed with you, we believe that the deductions cannot be disallowed solely on the basis of a captive arrangement and the economic family rationale. We recommend proposing an adjustment only if the payments were either excessive in amount (section 482 adjustment) and/or extremely excessive in nature (sham transaction adjustment). However, based on our review of the

current administrative file, it appears that no proposed adjustment is warranted primarily because the payments made by [redacted] to [redacted] appear to be for arms-length amounts and are not sham transactions.

The rationale for our legal conclusions and recommendations, as well as my understanding of the facts upon which they are based, are set forth below.

Facts

In [redacted], [redacted] was formed following a divisive reorganization that segregated the [redacted] related activities from other activities engaged in by [redacted] predecessor, [redacted] had employed captive insurance subsidiaries to provide workman's compensation insurance and the Service disallowed the premiums paid by [redacted] and its subsidiaries to the captive insurance subsidiaries (and the disallowance was eventually upheld by both the Tax Court and the [redacted] Circuit). In partial response, [redacted] was created to provide workman's compensation insurance for the [redacted] activities engaged in by [redacted] and some of its subsidiaries.

[redacted] was organized as a captive insurance company under the state of [redacted] Articles of incorporation were filed and a certification of incorporation was issued by the [redacted] Secretary of State. The [redacted] Department of Banking, Insurance and Securities authorized [redacted] to transact business as a captive insurer and write workers' compensation coverage, and the state also periodically issued [redacted] certificates of good standing.

[redacted] and [redacted] are commonly controlled as follows: All of the voting stock of [redacted] is owned by a trust. The co-trustees of the trust are [redacted] and [redacted], children of [redacted] (both deceased). The beneficial interest in the trust are split evenly between the children of [redacted] Neither [redacted] nor [redacted] is a beneficiary of the trust. The stock of [redacted] is owned by a partnership in which [redacted] and [redacted] each hold a 50 percent interest.

During [redacted] and [redacted] [redacted] and some of its subsidiaries paid "premiums" to [redacted] in exchange for [redacted] providing workers' compensation coverage for its [redacted] operations in various states, including [redacted]

[redacted] The current information in the administrative file indicates that the rates [redacted] charged [redacted] and its subsidiaries were within the range of third party insurers rates for similar insurance and/or the published National Council on Compensation Insurance (NCCI) rates for the Atlantic and Gulf states. [redacted] reinsured a portion (but not all) of its risks with third party insurers. Neither [redacted] nor any of its subsidiaries indemnified [redacted] from losses on its workers' compensation coverage for [redacted] and its subsidiaries.

Law and Analysis

Generally, premiums paid for insurance are deductible under section 162(a) if directly connected with the taxpayer's trade or business. Treas. Reg. § 1.162-1(a). Although the Internal Revenue Code does not define the term "insurance," the Supreme Court has stated that to constitute "insurance," a transaction must involve "risk shifting" (from the insured to the insurer) and "risk distribution" by the insurer. Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). In this regard, amounts set aside by a taxpayer as a "self-insurance" reserve for anticipated losses are not insurance expenses because risk is not shifted from the taxpayer; therefore, such amounts are not deductible until the taxpayer actually pays or accrues the anticipated loss. United States v. General Dynamics Corp., 481 U.S. 239, 243-244 (1987).

In instances where the taxpayer enters into an "insurance" arrangement with a related "insurance" company, both the Service and the courts have attempted to address whether sufficient risk shifting is present in order for the transaction to be considered insurance. In Rev. Rul. 77-316, 1977-2 C.B. 53, the Service addressed three situations whereby a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through the taxpayer's wholly-owned captive insurer subsidiary. The Service concluded that the transactions were not insurance to the extent that risk was retained by the captive insurance subsidiary. The Service reasoned that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary, represented one "economic family" for purposes of the risk shifting analysis. Consequently, although risk shifted among separate entities within the economic family, the transaction did not result in sufficient risk shifting to constitute "insurance" because the economic

burden of losses remained within that family. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries were not deductible.

Courts have uniformly held that transactions between a parent and its captive insurance subsidiary do not constitute "insurance" where the captive "insures" only entities to which its is related. E.g., Stearns-Roger Corp. v. Untied States, 774 F.2d 414 (10th Cir. 1985); Carnation Company v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), aff'g. 71 T.C. 400 (1978); Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985). Nevertheless, no court so holding has totally accepted the economic family theory as set forth in Rev. Rul. 77-316. Although some of the earlier cases involving parent-subsidiary transactions appear to endorse the essence of the economic family theory, those cases do not expressly rely upon the theory due to apprehension that it will be invoked outside of the context of captive insurance and run afoul of the doctrine of separate corporate existence set forth in Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943).[1] See AMERCO, Inc. v. Commissioner, 979 F.2d 162, 166 (9th Cir. 1992) (explaining reluctance of courts to accept the economic family theory). In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), the Ninth Circuit attempted to reconcile its refusal to characterize a parent-subsidiary transaction as insurance with Moline Properties by fashioning the "balance sheet test." Under this approach, the court in Clougherty Packing reasoned that a parent-subsidiary transaction is not insurance because a loss covered by the captive subsidiary will reduce, dollar for dollar, the value of the insurer's stock reflected on the parent's balance sheet. The court reasoned that such an approach is consistent with Moline Properties because the parent's assets are viewed apart from the captive insurance subsidiary's assets. Clougherty Packing, 811 F.2d at 305.

Employing the balance sheet test set forth in Clougherty Packing, both the Sixth Circuit and the Federal Claims Court have held that payments to a captive

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[1] In Moline Properties, the Court held that absent an exception, e.g., where the corporation is a sham, a corporation should be viewed as a separate taxable entity. Accordingly, in contexts other than insurance, such as sales, leases or loans, both the Service and the courts have recognized for tax purposes the validity of transactions between related entities if the essential elements of the transaction are present and the entities acted at arm's length.

insurer by a sibling subsidiary were deductible as insurance premiums. Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Kidde Industries, Inc. v. United States, 40 Fed.Cl. 42 (1997). In both Humana and Kidde, the captive in question insured risks only within its related group. Both courts reasoned that, unlike parent-subsidiary transactions, sufficient risk shifting existed with respect to the brother-sister transactions because a loss incurred by the insured subsidiary did not diminish the assets reflected on that subsidiary's balance sheet when the captive paid the claim. Relying upon Moline Properties, each court explained that brother-sister transactions should be considered insurance for Federal income tax purposes unless either the captive entity or the transaction itself is a sham. Humana, 881 F.2d at 255; Kidde, 40 Fed.Cl. at 47.

Similar to the relationship of [redacted] and [redacted] in Crawford Fitting Co. v. United States, 606 F.Supp. 136 (N.D. Ohio 1985), the Crawford Companies were not a separate parent-subsidiary group but were a group of separate corporations that were owned and controlled by a group of related individuals. The district court held that insurance premiums paid to a captive insurance company were deductible as ordinary and necessary business expenses because the taxpayer and the other shareholders of the captive were not so economically related that their separate financial transactions had to be aggregated and treated as the transactions of a single taxpayer.[2]

Based on the above, it is clear that whether the transaction between [redacted] and [redacted] is insurance is not determined solely by the economic family theory. Brother-sister transactions, as well as the more attenuated arrangement present in the instant case, are subject to the same standards as those applied to unrelated parties who enter into purported "insurance" transactions. Thus,

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[2] In addition, [redacted] can only be a [redacted] captive insurer by application of the section 318 attribution rules. To date, we are not aware of any court that has considered a captive insurance case in which the relationship between the corporations is based on the application of the attribution rules and we doubt a court would apply section 318 attribution in this context. This is because section 318(a) provides that the section applies only where they "are expressly made applicable" and section 162 does not make expressly make section 318 applicable to the determination of ordinary and necessary business expenses.

whether the transaction constitutes insurance is a facts and circumstances question that includes a determination of whether (among other things): (1) the insurer was organized and operated as an insurance company; (2) the insurer was regulated by insurance law; (3) the insurer is adequately capitalized; (4) the premiums charged were based on arm's-length transactions; and (5) the unpaid losses held by the insurer bear a rationale relationship to claim experience.

The current information contained in the administrative file indicates that the transactions between [redacted] and [redacted] appear to be valid insurance transactions. [redacted] was organized and operated as a [redacted] insurance company and was regulated by [redacted] insurance law. More importantly, the premiums [redacted] and its subsidiaries paid to [redacted] were within the range of third party insurers rates for similar insurance and/or NCCI published rates for the Atlantic and Gulf states. While [redacted] reinsured a portion of its risks with third party insurers, it remained liable for a portion of the risks. Neither [redacted] nor any of its subsidiaries indemnified [redacted] from losses on its workers' compensation coverage for [redacted] and its subsidiaries. Because the payments made by [redacted] to [redacted] appear to be for arms-length amounts and are not sham transactions, no adjustment under section 482 or a sham transaction theory seems warranted. See footnote 1, supra.

Conclusion

We believe that the deductions [redacted] and its subsidiaries claimed for premiums paid to [redacted] cannot be disallowed solely on the basis of a captive arrangement and the economic family rationale. Furthermore, because the payments made by [redacted] to [redacted] appear to be for arms-length amounts and are not sham transactions, no adjustment under section 482 or a sham transaction theory seems warranted

If you have any questions, or if we could be of any more assistance, please do not hesitate to call the undersigned at 220-5951.

/s/ KGM

KEITH G. MEDLEAU
Attorney